Conversion blues for FCCB issuers

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Stocks below conversion price as maturity nears; earnings to be hit.

Even as Corporate India is benefiting from the economic recovery in the country, there are some companies which are soon going to be in a Catch-22 situation. These companies had issued Foreign Currency Convertible Bonds (FCCBs) in 2005-06, which are due for maturity between end of 2010 and mid-2011. Their stocks are currently trading on average 47 per cent below their conversion price. Analysts say their companies' options are few.

Options

Many midcap companies had issued FCCBs in 2005-06 as it gave them access to cheap foreign currency debt, while providing bondholders the option to convert the bonds into equity within the pre-determined period and price. Among the list of FCCBs issued by India Inc are some whose share prices are currently trading up to 70 per cent below the conversion price and scheduled to mature in the near term. Among these are some well-known midcap companies such as Bajaj Hindusthan, HCC, Videocon Industries, Aban Offshore, India Cement, Jubilant Life Sciences, Glenmark Pharma and Punj Lloyd.

In this backdrop, experts believe there is very little hope for them in terms of bondholders applying for conversion into equity shares, unless they reduce the conversion price to realistic (market) levels. However, even in that case, it will lead to higher than expected equity dilution.

Says Ambareesh Baliga, VP, Karvy Stock Broking, "When the FCCBs are issued, analysts take into account that it will be converted and they include that in the diluted equity capital for their (EPS) calculations. But, with companies whose stock price has fallen steeply, where instead of one share, the FCCB holder gets four shares or so for each bond (due to downward revision in conversion price), this whole equation will change."

However , Deven Choksey, Managing Director, KR Choksey Securities, says, "It may not always affect them negatively. After the conversion of FCCBs, the equity component may look up and the financials (as well as the debt-equity ratio) of the company may also improve."

There are other issues as well. Alex Mathew, Research Head of Geojit BNP Paribas says, "If the promoter does not hold a lump sum stake in the company, re-issuing the bonds at a lower price would pave the way for a hostile takeover."

For now, most analysts believe redemption is the only logical option.

India Cements' shares are trading 63 per cent below the conversion price of FCCBs. V M Mohan, Joint President-Corporate Finance, India Cements, says, "We are contemplating redeeming the debentures on maturity as there is a high discount gap and an accretive value on the bond."

REDEMPTION CALL

	CMP (Rs) *	FCCB Amt ($ mln)	FCCB Maturity date	FCCB Conversion price (Rs)	Diff ** (%)
Panacea Biotec	210	36.8	Feb 11	358	-41.3
Amtek India	64	47.0	Oct 10	120	-46.5
Bharati Shipyard	272	46.9	Oct 10	498	-45.3
3i Info	68	20.2	Mar 11	115	-41.0

Bajaj Hind	129	99.6	Feb 11	465	-72.4
HCC	63	100.0	Mar 11	248	-74.7
Videocon Ind	263	42.3	Feb 11	449	-41.4
Amtek Auto	167	136.1	June 11	210	-20.6
Aban Offshore	813	66.1	Apr 11	2789	-70.8
India Cement	115	75.0	May 11	306	-62.5
Jubilant Life Sci.	313	142.1	May 11	413	-24.2
Glenmark Pharma	324	30.0	Jan 11	583	-44.4
Punj Lloyd	125	49.7	Apr 11	273	-54.0

*** difference between current price and conversion price*
** Closing stock price as on October 27, 2010*
Source: BS Research

What are the implications?
"Companies will have to take a loan to repay the FCCB debt, and the transaction will get accounted in the books," added Mehul Savla, investment banker and founder of Ripple Wave Equity. FCCBs are zero-coupon bonds and companies have to pay the redemption amount along with the compounded interest. Under prudent accounting principles, the transaction (repayment to FCCB holders) will entail the company charging the interest paid to the profit and loss account, thereby impacting profits in that fiscal to that extent. The other option, says an analyst, is "companies may take shareholders' approval to write off the interest amount against the reserves".

As far as fresh debt (to repay FCCB) is concerned, it could mean a higher interest outgo in the interim. "For midcap companies, liquidity could prove to be a concern, and taking a loan at 11-12 per cent from the banks to pay off these bondholders will be difficult and expensive," says the head of a broking firm.

What you should do
Investors will need to take a case-by-case approach, dwelling into the company's financial strength, position in the industry, the quantum of FCCB (in relation to total debt; for Aban, Bharati Shipyard, HCC, Glenmark, etc, it is less than 10 per cent of the total debt) and so on.

Investors will also need to keep a watch on the steps companies take on this front. Also, says Choksey, "Some of these companies, like Glenmark and Bharati Shipyard, may start quoting higher going forward before the conversion takes place. Investors in such companies should continue to hold these stocks until they get a better price."